

Report to the General Assembly

June 1991

A Sunset Review of the South Carolina Department of Insurance



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Report to the General Assembly

**A Sunset Review
of the South Carolina
Department of
Insurance**

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Executive Summary

Pursuant to state law, we reviewed the operations of the South Carolina Department of Insurance. Our eight objectives, established by state law, are found on page 1. In this audit, we did not attempt to determine whether the department correctly approved any specific rate, rule, or form. We did not examine any specific line of insurance or any specific insurance rate. In addition, we did not examine the financial condition of any specific company.

We found that there is a public need for the department of insurance and it should be reauthorized. However, we found that the department could improve some aspects of its regulation of the insurance industry.

Throughout the department, we found a need for written policies and procedures. The agency regulates more than 1,400 insurance companies which received approximately \$4.5 billion in premiums from South Carolina consumers in 1989. It is responsible for ensuring compliance with more than 800 pages of state laws. As the size and complexity of an organization increases, so do the benefits which can be derived from written policies and procedures. These benefits include thoroughness and consistency of operations.

In conjunction with the eight objectives established by state law, we examined three functions of the department which affect consumers. These include: (1) the process for approving insurance rates, rules, and forms; (2) consumer assistance, complaint investigations, and the licensure of agents and companies; and (3) the regulation of insurance company solvency. To better summarize this report, the executive summary presents our major findings in a question and answer format.

Rates, Rules, and Forms

Does the department have a system for ensuring that it approves rates, rules and forms, used by insurance companies, in a thorough and consistent manner?

The department does not have adequate policies and procedures for its analysts, including procedures for documenting the rationale for decisions. The department does not audit data submitted by insurance companies to support rate requests. Also, the department does not have an adequate

system to assess whether out-of-state companies use rates, rules, and forms which have been approved by the department (see p. 5).

Is government regulation of insurance rates needed?

Although state law requires the department to approve rates for certain lines of insurance before companies may use them, the insurance department has not formally studied the costs and benefits of rate regulation. Studies of regulatory systems across the country have shown that rate regulation can sometimes be effective at reducing rates but can also be accompanied by negative side effects. For lines of insurance where prior approval of rates is ineffective or produces significant negative side effects, it may be prudent to institute a less restrictive form of regulation or permit competition to regulate rates (see p. 9).

Can insurance agents offer discount insurance prices by reducing their commissions?

State law restricts agents from rebating any portion of their commissions. We believe that allowing insurance agents to discount the price of insurance by offering rebates to their customers would benefit the consumer. This practice is permitted in California and Florida (see p. 14).

Consumer Assistance, Investigations, and Licensure

Does the department investigate and respond to consumer complaints promptly and effectively?

The department handled more than 19,000 written consumer complaints from 1987 through 1990. In most cases, the department responded to complaints promptly and ensured that consumers received an answer to their complaints. However, we found that the department needs more specific written policies and procedures to better ensure that complaints are properly documented, investigated, and resolved (see p. 17).

Does the department effectively provide consumers with information to assist in shopping for insurance?

The department provides "shoppers' guides" for automobile, homeowners, and health insurance, and department staff give numerous speeches on insurance matters. However, the department does not have a program to actively distribute information, to advertise which consumer services are available, or to assess and plan for consumers' educational needs. Providing more consumer education can help consumers make better informed decisions when purchasing insurance (see p. 22).

Does the department license agents and companies in compliance with state laws?

We found no significant deficiencies in the department's monitoring and enforcing of licensing standards for insurance agents. However, the department needs to develop written policies and procedures outlining its process for licensing insurance companies (see p. 29).

Solvency Regulation

Does the department have procedures which are likely to detect financially unsound insurance companies in a timely manner?

The department relies on financial analysis provided by the National Association of Insurance Commissioners Insurance Regulatory Information System (NAIC IRIS), and its own analysis and examination procedures to detect financially unsound companies. However, the department needs specific procedures for assessing insurer financial condition (see p. 33).

Introduction and Background

Audit Objectives

This audit was conducted in accordance with §1-20-10 of the South Carolina Code of Laws. Our overall objectives were established in state law as follows:

- (1) Determine the amount of the increase or reduction of costs of goods and services caused by the regulations promulgated by and the administering of the programs or functions of the agency under review.
- (2) Determine the economic, fiscal, and other impacts that would occur in the absence of the regulations promulgated by and the administering of the programs or functions of the agency under review.
- (3) Determine the overall cost, including manpower, of the agency under review.
- (4) Evaluate the efficiency of the administration of the programs or functions of the agency under review.
- (5) Determine the extent to which the agency under review has encouraged the participation of the public and, if applicable, the industry it regulates.
- (6) Determine the extent to which the agency duplicates the services, functions and programs administered by any other state, federal, or other agency or entity.
- (7) Evaluate the efficiency with which formal complaints, filed with the agency concerning persons or industries subject to the regulation and administration of the agency under review, have been processed.
- (8) Determine the extent to which the agency under review has complied with all applicable state, federal, and local statutes and regulations.

These eight issues are addressed in Chapter 5. Along with the eight sunset issues, we reviewed major regulatory functions of the department to:

- Determine how the department approves rates, rules and forms.
- Determine how the department investigates complaints, provides consumer information, reviews the market conduct of insurance companies, and licenses applicants.

- Determine how the department ensures that companies are solvent.

These issues are addressed in Chapters 2, 3, and 4.

Scope and Methodology

This review primarily covers the time period from 1987 through 1990. We examined department records, written policies and procedures, and state and federal laws. We interviewed department of insurance officials and other state government officials, and officials in other states. We compared regulatory practices in South Carolina to those in other southeastern states.

We examined department internal controls used to ensure compliance with state laws. We used certain insurer financial information from the department's automated data processing system. This information was not integral to the audit objectives. We did not evaluate the controls over the department's data processing system. This audit was conducted in accordance with generally accepted government auditing standards.

Background and Organization

South Carolina established a Department of Insurance in 1908. In 1960, the department was placed under a five-member commission. State law passed in 1980 changed the commission. It now consists of seven members: one from each congressional district and one at-large member. All are public members not associated with the insurance industry, are appointed by the Governor for a six-year term, and are limited to one term. State law created an advisory committee to assist the commission in insurance matters. Members of the insurance industry compose the advisory committee.

The department is responsible for administering and enforcing the statutes under which insurance companies operate. Some of the commission's objectives include assuring the fair treatment of policyholders, increasing the public's understanding of regulation of the insurance industry, making insurance available at appropriate rates, and protecting the public from insolvent insurers.

State law charges the commission with the responsibility of hiring the Chief Insurance Commissioner. The commissioner, who serves a four-year term,

is the administrative head of the department. In FY 90-91, the department had 119 authorized positions.

The department is organized along functional lines into divisions. The following briefly describes five major divisions. The department's organizational structure is outlined in Appendix A. In addition, a glossary of insurance terms is found in Appendix C.

**Financial Condition
Division**

The financial condition division is charged with protecting the public from insurance company insolvency. To accomplish this, the division employs financial analysts and examiners. Analysts perform in-office reviews of all insurer annual financial reports. Examiners perform on-site audits of insurers domiciled (headquartered) in South Carolina.

**Licensing and Taxation
Division**

This division administers statutes and regulations governing the licensing and taxation of insurance companies. The division is responsible for collecting fees and taxes. It also licenses agents, agencies, brokers, adjusters, bail bondsmen, and appraisers. The division assists the State Treasurer in distributing fees and taxes to cities and political subdivisions.

Market Conduct Division

The division protects policyholders and claimants from unfair sales and advertising, underwriting, claims handling, and premium service practices. The division investigates complaints and assists in getting them resolved. The division also investigates companies and agents alleged to have violated insurance laws.

**Life, Accident and
Health Division**

This division is responsible for ensuring that rates and forms for life, annuity, accident and health, and health maintenance organization policies issued are in compliance with state law.

Chapter 1
Introduction and Background

**Property and Casualty
Division**

The division analyzes and approves rates, rules, and forms for most lines of property and casualty insurance.

Rates, Rules, and Forms

In this chapter we address the insurance department's system for regulating rates, rules, and forms. We address the need for rate regulation. We also review state laws which prohibit insurance agents from discounting insurance prices by sharing their commissions with consumers.

System for Regulating Rates, Rules, and Forms

State law requires that the insurance department approve rates and forms for most lines of property and casualty insurance. Forms include insurance policies and related documents. The department also requires prior approval of insurance rules for most lines of property and casualty insurance, although they are not mentioned in state law or regulation. Rules, according to department officials, are instructions developed by insurance companies for determining how to implement insurance rates.

In addition, state law requires that the insurance department approve rates and forms for certain lines of life, accident, and health insurance.

Appendix B outlines specific lines of insurance regulated with regard to rates, rules and forms.

Below we recommend actions which will give greater assurance that the rate, rule, and form approval process is conducted and documented thoroughly and consistently.

Written Policies and Procedures

For property and casualty insurance, the department does not have a policies and procedures manual to guide analysts in determining whether to approve rates, rules, and forms. Analysts use state laws and regulations in addition to a limited number of department bulletins and orders. When asked about developing written policies and procedures outlining this approval process, a department official expressed concern about "restraints that would necessarily be brought about through the establishment of set procedures." The official stated that there are diverse actuarially sound approaches for determining any particular rate. In addition, this official stated that companies must be reviewed on an individual basis to ensure that rates are in compliance with state laws and regulations.

For life, accident, and health insurance, the department has memoranda, bulletins, guidelines, and other documents for analysts to follow when

reviewing rates and forms. The division responsible for life, accident, and health insurance has a policies and procedures manual, but it has not been updated since 1983. A department official stated that heavy workloads have hindered efforts to update this manual but that there are plans to do so.

Section 1-23-140 of the South Carolina Code of Laws (Administrative Procedures Act) requires that state agencies adopt and make available to the public a written policy statement of all formal and informal procedures. A policies and procedures manual can increase the likelihood that an organization's activities are conducted thoroughly and consistently. Where it is necessary, such policies and procedures can be flexible, so that their costs do not exceed their benefits.

Documentation of Analysis

The department has not developed written policies or procedures requiring analysts to document the analysis they conduct to determine whether rates, rules, and forms are in compliance with state laws and regulations.

In practice, department analysts for both property and casualty insurance and life, accident, and health insurance use similar methods to document their reviews. Files sometimes include letters to companies which communicate areas of noncompliance. In addition, analysts sometimes make notations such as check marks, brief notes, and brief calculations in the margins of documents submitted by insurance companies.

However, without formal documentation of the steps taken to analyze a filing and the rationale for the final decision, there is inadequate evidence that the analysis is conducted thoroughly and consistently.

Formal documentation procedures could increase paperwork. However, we believe procedures could be established to minimize this effect.

State Regulations

For certain lines of insurance, the department's rate approval criteria are not in state law or regulation. Sections 1-23-10 and 1-23-40 of the South Carolina Code of Laws require that "each agency statement of general public applicability that implements or prescribes law or policy or practice requirements" be promulgated through regulation. Rate approval criteria not currently in state law or regulation may be required to be promulgated through regulation.

According to state law, property and casualty rates which require prior approval ". . . may not be excessive, inadequate, or unfairly discriminatory." Department analysts use various methods and criteria for implementing this requirement depending on the line of insurance and the professional background of the analyst. We did not assess the validity of any particular criteria or the validity of using different criteria. However, except for credit property insurance, neither state law nor state regulation contain criteria for determining whether property and casualty rates are in compliance with state law.

For all lines of individual accident and health insurance, as well as group rates for mass-marketed insurance, state law requires that benefits be reasonable in relation to premiums charged. Rates for health maintenance organizations (HMO) may not be excessive, inadequate, or unfairly discriminatory. The department uses specific loss ratios (losses/earned premiums) as rate approval criteria, but they have not been established in a consistent manner. Minimum loss ratios for Medicare supplement, long-term care, and credit disability insurance are established in state law and/or regulation. For "major medical" insurance, state law requires that rates be "deemed" approved if companies file a loss ratio guarantee based on National Association of Insurance Commissioners' standards. Minimum loss ratios for all other lines of accident and health insurance for which prior approval of rates is required are established through department guidelines.

A minimum loss ratio for certain types of credit property insurance is set in state law. Rates for credit life insurance are set in state law.

The department's need for flexibility in reviewing rates can be incorporated into the regulations required by state law.

Verification of Rating Data

The insurance department does not conduct examinations (audits) to verify the accuracy of insurance company data used to justify the rates companies propose to use.

A department official stated that during solvency examinations of insurance companies, examiners test the accuracy of loss, premium, and expense data as reported on annual statements. Another department official stated that rating data are cross-checked with annual statements, reviewed by the consumer advocate, and presented under oath at public hearings. We received no documentation to indicate that rating data submitted by companies were inaccurate. However, periodic examinations of the specific

data submitted to the department in specific rate filings could help ensure the accuracy of information filed to justify rates.

Other state agencies audit data submitted by private companies. The South Carolina Public Service Commission audits data submitted by utility companies. The South Carolina Tax Commission audits tax returns.

A department official stated that, for the majority of insurers, it would be of limited value to conduct such examinations due to insufficient claims volume in a specific line of insurance to provide actuarially credible data. For companies with greater claims volume, this official stated that the time, expense, and complexity required to establish a system of on-site examinations of actuarial data for property and casualty rate filings would be excessive.

Since the insurance department grants prior approval of insurance rates based on insurance company data, limited on-site examinations of the data could increase public confidence in the rate approval process.

The Use of Approved Rates, Rules, and Forms

The insurance department does not have an adequate system to ensure that out-of-state insurance companies use only rates, rules, and forms which have been approved by the department. A department official stated that examiners review the use of approved rates, rules, and forms when they conduct solvency examinations of insurance companies. But, from 1985 through November 1990, the department participated in examinations of only 18 out-of-state companies. As of March 1991, there were more than 1,300 out-of-state companies licensed in South Carolina.

A department official also stated that based on consumer complaints, the department sometimes checks to ensure that approved rates are being used.

By increasing the number of out-of-state companies examined by the department, there would be a reduced risk that companies are using rates, rules, and forms which have not been approved by the department.

Recommendations

- 1 The insurance department should maintain comprehensive policies and procedures manuals for analysts to use when determining whether insurance rates, rules, and forms are in compliance with all relevant state laws and regulations. Such manuals should include procedures requiring analysts to document the steps they take in reviewing rates, rules and forms, and the rationale for all final decisions.
- 2 The insurance department should promulgate through state regulation those policies and procedures for which such action is required by state law.
- 3 The insurance department should periodically conduct on-site examinations of a limited number of in-state and out-of-state insurance organizations to test whether the specific data they have submitted in rate filings are accurate.
- 4 The insurance department should periodically conduct reviews of a limited number of in-state and out-of-state insurance companies to determine whether they are using rates, rules, and forms which have been approved by the department.

Assessing the Need for Rate Regulation

As described on page 5, state law requires prior approval by the insurance department of rates for certain lines of insurance. However, we found no formal studies conducted by the insurance department of the need for this type of rate regulation.

Some insurance lines for which rates are regulated are sold in competitive markets. In addition, rate regulation can sometimes be ineffective or have negative side effects. Below we present these and other factors which indicate that the need for rate regulation is not always clear.

Most of the information we found relating to this subject focused on property and casualty insurance in general, and automobile insurance in particular. We believe, however, that the issues we address can pertain to rates for other lines of insurance.

Competition Between Insurance Companies

In the case of a monopoly, such as an electric utility, rate regulation can compensate for the lack of competition from other companies. For more competitive industries, however, this benefit may not be as great.

A number of factors can be considered when determining whether an industry is competitive. Two significant factors are market concentration and barriers to entry. Market concentration is the degree to which a few firms hold market share. Barriers to entry are financial, technological, legal, and other limitations which make it difficult for a new firm to enter an industry. When market concentration and barriers to entry are low, an industry is more likely to be competitive.

A 1979 report from the General Accounting Office and a 1985 staff report of the Federal Trade Commission concluded that the automobile insurance industry does not have a high market concentration or significant barriers to entry.

Another factor which may affect competition is the level of consumer information about a product's price and quality. In Chapter 3, we recommend improvements in the department's program for providing consumer information.

Effectiveness of Rate Regulation

We reviewed studies comparing property and casualty insurance rates in states requiring prior approval of rates with states which rely on competition to regulate rates. Efforts to measure the effectiveness of rate regulation are complex and sometimes reach different conclusions. Some studies suggest that rate regulation may not have a significant impact on rates, while others suggest that it may. In a 1988 publication by the Brookings Institution, Scott Harrington, an insurance expert from the University of South Carolina, noted:

Regulation in [prior approval] states . . . probably has not had much impact on rates for commercial lines [of property and casualty insurance] in recent years because of passive administration of the laws, pricing flexibility provided to underwriters by rating plans, and other influences. In contrast, there is considerable evidence that rate regulation has lowered average prices for private passenger auto liability insurance in recent years. Evidence also suggests that

restrictive rate regulation is more likely in states with high losses per insured driver.

A similar conclusion regarding automobile insurance was reached in a 1986 General Accounting Office report. Thus, there is evidence that, in certain instances, state governments have the ability to produce rates lower than those produced by competition.

Side Effects of Rate Regulation

When rate regulation produces rates lower than those produced by a competitive market, there can be negative side effects.

In a 1990 paper, Harrington cited side effects such as:

... reductions in quality of service and exit of insurers from the market. Restrictive rate regulation also tends to produce fewer options for consumers and often involves long and costly rate hearings with numerous expert witnesses and attorneys for consumer advocates, regulators, insurers, and agents.

Harrington, the General Accounting Office, and J. David Cummins, an insurance expert from the University of Pennsylvania's Wharton School, noted that restrictive regulation of automobile insurance rates can contribute to a higher percentage of drivers being insured in a state's "involuntary market." An involuntary market consists of policies sold by companies, in compliance with state law, to drivers who fail to meet company underwriting standards. These drivers are generally subsidized by other drivers.

Rate Regulation in Other States

We surveyed other southeastern states and found a variety of rate regulation systems for insurance. In this section we summarize our findings of the rate regulatory systems for private passenger automobile and homeowners insurance.

State governments use various rate regulation systems, including the following:

Prior Approval - Companies are required to file rates and obtain approval of state government prior to using the rates.

File and Use - Companies are required to file rates with state government prior to using them. State government approval is not necessary.

Use and File - Companies are required to file rates with state government, but not until after they have begun to use the rates. State government approval is not necessary.

No File - Companies are not required to file rates or receive approval of state government.

It is important to note that within the above categories there are variations from state to state. In addition, distinctions between categories can be misleading. For example, a "file and use" state might have the authority to disapprove or require modification of rates which have been filed. If such authority were used actively, a "file and use" system would be similar to a "prior approval" system. On the other hand, a "prior approval" state which routinely approves rates with minimal modification would have a system similar to a "file and use" system.

Keeping in mind the limitations of comparing rate regulation systems, we found that states regulate rates for the same lines of insurance in different manners. For example, Table 2.1 lists the rate regulation systems used by southeastern states for private passenger automobile insurance and homeowners insurance:

Table 2.1: Rate Regulation Systems Used for Private Passenger Automobile Insurance and Homeowners Insurance

State	Rate Regulation System
Alabama	Prior approval.
Florida	Insurance companies may choose between a use and file system, in which the insurance department can subsequently disapprove rates and require refunds, and a file and use system.
Georgia	File and use.
Kentucky	Use and file for rate increases of less than 25% in a 12-month period. Prior approval for increases of 25% and more in a 12-month period.
Louisiana	Prior approval.
Mississippi	Prior approval.
North Carolina	Prior approval.
South Carolina	Prior approval.
Tennessee	Prior approval.
Virginia	File and use except for uninsured motorist insurance, which requires prior approval.

Conclusion

A periodic study of the costs and benefits of regulating South Carolina insurance rates could provide useful information. For lines of insurance where prior approval of rates is ineffective or produces significant negative side effects, it may be prudent to institute a less restrictive form of regulation or permit competition to regulate rates.

Recommendations

- 5 The insurance department should conduct, on a periodic basis, formal studies of the costs and benefits of regulating insurance rates for each line of insurance sold in the state. These studies should address factors including:
 - Industry competitiveness.

- The effectiveness and side effects of rate regulation.
 - Regulatory practices in other states.
- 6 Based on the department's formal studies, where the benefits of requiring prior approval of rates cannot be shown to outweigh the costs, the department should recommend that the General Assembly institute a less restrictive form of regulation or permit competition to regulate rates.

Regulation of Insurance Agents' Commissions

South Carolina state laws prohibit any insurance company or agent from offering rebates to individual consumers in attempting to sell insurance. This means that agents are unable to offer lower prices to consumers by sharing or refunding part of their commissions. In addition, agents or insurers cannot give their customers any kind of financial inducements or gifts worth more than \$5 as an incentive for the customer to buy their insurance product. (For example, insurance agents could not give fire extinguishers or smoke alarms for promotional purposes to customers buying homeowners' insurance.) These restrictions make it more difficult for agents to compete against one another on the basis of price.

Until recently, all states had "anti-rebate" laws. In 1986, however, the Florida Supreme Court ruled that Florida anti-rebate laws were an unconstitutional limitation on the bargaining power of consumers. The court said it could not find any identifiable relationship between the anti-rebate statutes and a legitimate state purpose in safeguarding the public health, safety, or general welfare. In addition, California legalized rebating with the passage of Proposition 103 in 1988.

Those who favor legalized rebating believe it would encourage competition and thus efficiency; allow policyholders to purchase insurance at a lower cost; and allow the agent to charge fees that more accurately reflect the cost of doing business. Currently agents collect the same percentage commission for most policyholders, even though some consumers obtain more services than others.

Supporters of anti-rebate laws contend that rebating would give a competitive advantage to larger insurance agencies because of high sales volume and would force smaller agencies out of business; that consumers might change agents every year in order to get more rebates, thus causing higher lapse

rates which could drive up the cost of insurance or even threaten the future solvency of insurers; that large, commercial customers would benefit more from a rebate system than small, individual consumers; and that consumers would purchase policies based on the size of the rebate rather than the long-term cost and value of the policy.

The Florida courts disagreed with the argument that rebates of agents' commissions could adversely affect the solvency of an insurance company. The Florida courts also ruled that rebates were not unfairly discriminatory, as long as the net premium paid to the company remains the same for each individual within an actuarial class. In other professions and the retail trades, sales fees are negotiable and/or rebates and discounts are not prohibited by law, on the assumption that consumers will know their own best interests if they are well-enough informed.

Recently, guidelines for rebating were established in Florida's insurance laws. Factors which are unfairly discriminatory, such as age, sex, or race, cannot be used to decide when to offer a rebate or the amount of the rebate. Agents are not required to offer rebates, and the insurance company can forbid its agents to offer rebates. However, each agent must offer the same rebate to all customers who buy the same policy with the same coverage and who are in the same risk classification.

We contacted the Florida and California departments of insurance to determine their experience with legalized rebating. Florida has not encountered consumer complaints with rebating but neither is the practice widespread. California is in the process of promulgating regulations to carry out the mandates of Proposition 103; however, a California Insurance Department spokesman told us that rebating is expected to be utilized by agents in that state.

We found one possible exception to anti-rebate laws in South Carolina. In 1990, an amendment to state law allowed insurance companies and agents to pay a fee to tax-exempt trade and professional organizations. This may allow such organizations to negotiate a rebate on coverage for their members.

State law also permits premium discounts for life, accident, and health insurance policies that are issued under a franchise or wholesale plan. Franchise insurance is an insurance policy approved and endorsed by a group or association and sold on an individual basis to members. Insurance companies can incur lower costs when selling insurance on a franchise plan and thus can pass these savings on to policyholders. Generally speaking,

insurers and group policyholders are free to negotiate the terms and premiums for a group insurance policy.

We found no unique aspects of the insurance business which would justify restricting an agent's ability to compete through offering rebates.

Allowing agents to discount the price of insurance by offering rebates to their customers could be in the best interest of the consumer and help make the insurance industry more competitive.

Recommendation

-
- 7 The General Assembly may wish to consider amending state law to permit all insurance agents to rebate or otherwise share with their customers any portion of the commissions they receive from insurance companies.

Consumer Assistance, Investigations, and Licensure

The issues affecting insurance consumers concern not only the price of insurance but also how consumers are treated by licensed insurance companies and agents. State insurance laws specifically prohibit unfair and fraudulent treatment of policyholders. For example, deceptive advertising of insurance benefits, discriminatory sales practices, and refusal to settle insurance claims in good faith are actions that violate state law.

In the first part of this chapter we review the department's programs for resolving consumer complaints and assisting consumers who need information about insurance. The second part reviews department systems for monitoring the treatment of policyholders and investigating alleged violations of insurance laws. How the department enforces requirements for licensing agents and companies is assessed in the third part of this chapter.

Consumer Assistance and Education

A major function of the department of insurance is to help consumers with questions and complaints about insurance. Consumer assistance and complaint investigations are handled by the market conduct division within the department. Staff from this division as well as from the commissioner's office conduct consumer information and education activities. The following describes how the department handles consumer complaints and educates the public on insurance matters.

Assistance and Complaints

The department processed approximately 51,540 inquiries and 19,750 written complaints from 1987 through 1990. In addition, in January 1990, the department installed a toll-free telephone "hotline" for consumers as we recommended in our 1985 audit of the department. Over the hotline alone, from January through September 1990, the department received about 7,850 calls from consumers.

Table 3.1 demonstrates the number of complaints by major lines of insurance and the total percent increase (decrease) from 1987 through 1990. This data shows that the number of consumer complaints increased the greatest for accident and health insurance (72%) and homeowners insurance (186%). The increase in homeowners insurance complaints was largely due to Hurricane Hugo.

Table 3.1: Complaints by Type of Insurance

	1987	1988	1989	1990	Percentage Increase/ (Decrease)
Total Complaints	4,150	4,145	5,289	6,173	49%
Accident and Health	1,479	1,676	2,052	2,550	72%
Auto ^a	1,332	1,211	1,360	1,452	9%
Life	708	713	682	694	(2%)
Homeowners ^b	340	311	833	974	186%
Other ^c	291	234	362	503	29%

^a Includes automobile liability and physical damage.

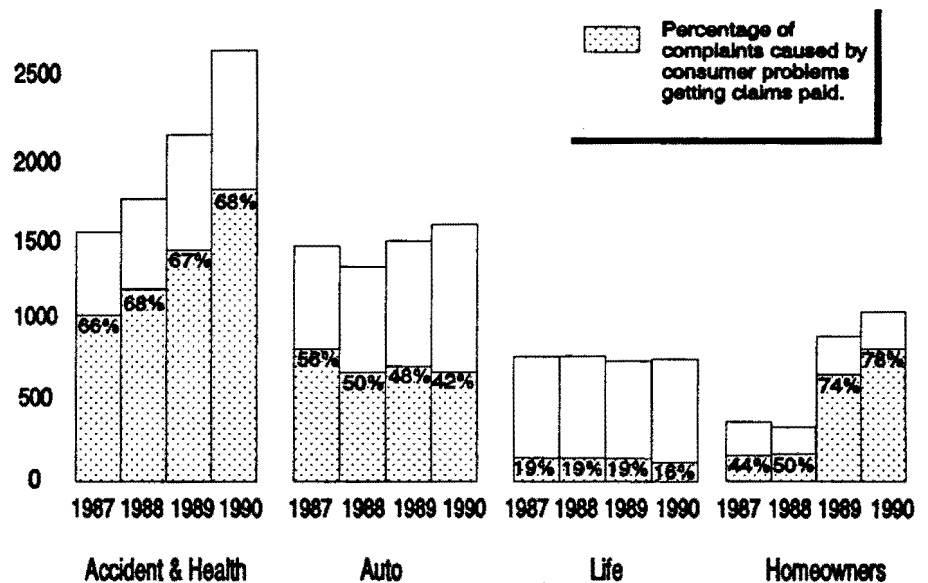
^b Includes mobile homes.

^c Includes annuities, fire, commercial liability, workers compensation, fidelity and surety, title, and all other lines of insurance.

The most frequent single cause for complaints was claims-handling by companies. This included complaints about delays in payments, denial of claims, and unsatisfactory settlements by insurance companies. The exception to this was life insurance, where consumer problems in getting claims paid accounted for less than 20% of complaints.

The shaded areas in the bar chart which follows represent the percentage of complaints, for personal lines of insurance, that were caused by consumers' problems with payment of claims.

Graph 3.2: Total Complaints for
Personal Lines of Insurance:
1987-1990



Complaint Handling

We reviewed a statistically representative sample of 73 complaint files which were processed between 1987 and 1989. The aim of this review was to evaluate the efficiency and effectiveness of the department in handling consumer complaints and to determine if the complaint data kept by the department helped identify specific consumer problems.

Of the 73 complaints selected for review, two were still open and one complaint file could not be located. The average length of time taken to resolve a consumer complaint was 44 days. Since department consumer assistants usually give an insurance company 30 days to reply to a complaint,

this time span indicates that the department processed complaints in a timely manner. We found that in 96% of the complaints, the department sent a letter to the consumer acknowledging the complaint, and in 90% of the cases the department sent a letter to the insurance company directing it to respond to the complaint.

We concluded that, in most cases, the department helps consumers by intervening in the complaint process and ensuring that consumers obtain a response from insurance companies when they have a problem.

Based on our sample, interviews with department staff and a review of relevant documents, we noted a need for greater detail in complaint handling procedures. While the market conduct division has a policies and procedures manual, it does not offer specific guidance in two areas:

- The policies and procedures manual does not have specific guidelines on how complaint files should be documented. It only mentions that consumer assistants are to "maintain records of complaints." For example, some consumer assistants kept a record of telephone conversations they had in the process of resolving a complaint, while others kept no such records.

We also found no documentation to show when a file had been referred to the department's legal or investigations staff for further analysis (although the department reported it began to record this in 1990). In 11 out of 70 closed complaints, we were unable to determine if the complaints had been investigated adequately because of incomplete documentation.

- The market conduct division does not have detailed procedures requiring that supervisors review the decisions made by consumer assistants. Although the procedures specify that all complaint correspondence is to be reviewed, we found no documentation of supervisory review in closed complaint files. A department staff member said that correspondence from new consumer assistants is reviewed by the supervisor.

Written and defined procedures for handling complaints would help ensure that complaints are properly documented, investigated, and resolved.

Recommendation

- 8 The department should update its written policies and procedures for complaint handling.
-

Complaint Information System

The present computer coding format used by the department to compile complaint data does not supply needed information in certain areas. The department classifies complaint information based on a format developed by the National Association of Insurance Commissioners (NAIC). While the information obtained is useful and forms the basis of an annual complaint study, more specific data are needed.

The department's system does not track complaints for individual insurance agents, although this information is needed by investigators when they are building a case against individual agents who have violated state laws and regulations. Seventy-seven percent of investigations concern allegations of agent wrong-doing.

The current information system also does not track complaints by type of accident and health insurance (such as long term care, individual health or Medicare supplement policies) or by type of insurance provider (such as HMOs or third-party administrators). As a result, complaint data about accident and health insurance are grouped together. The large number of consumer complaints about accident and health insurance, 7,757 from 1987 to 1990, indicates the need for analysis in this area.

In addition, the complaint recording form in use is not specific enough in classifying the outcome of a complaint. Consumer assistants, when a complaint file is closed, indicate whether the department was able to give "relief" or "no relief" to the consumer. But the code format in use is not clearly defined and we found that, in 17 of the 70 complaint files studied, either of the disposition codes could have been applied. The outcomes of these complaints, therefore, were subject to two interpretations as to whether relief had actually been given to the consumer.

In 1988, the NAIC adopted a revised consumer complaint recording form for use by state insurance departments. This format contains more specific data on complaints, and could be used to track trends in consumer insurance problems. In addition, the NAIC is developing a nationwide complaint database to use for compiling and sharing complaint information on a uniform basis. The NAIC is making final revisions to the 1988 complaint

recording form so that it might serve as the standard layout for complaint data to be shared among all states.

The pattern of consumer complaints is a valuable source of information about insurance problems encountered by consumers. By classifying complaint data in more detail, the department might be able to pinpoint and correct insurance practices that cause problems for consumers.

Recommendation

- 9 The department should consider using or adapting the 1988 NAIC complaint recording format when it next upgrades its computer processing capabilities for the market conduct division.
-

Consumer Education and Information

Insurance is a complicated product. Consumers need information on price and quality so they can make informed decisions when choosing between insurance companies or types of policies. In order to help consumers with questions and problems about insurance, the department engages in many kinds of consumer assistance activities:

- Complaint handling (see p. 19).
- Answering consumers' general requests for information, such as the A.M. Best's rating for a company; in 1990, the department answered more than 17,000 requests for information.
- Helping consumers understand their policies and the rates they are being charged.
- Helping consumers who cannot find insurance locate a company or agency willing to cover them.
- Providing "shopper's guides" for health, automobile, and homeowners insurance.
- Publishing a price comparison of the 20 largest companies selling automobile insurance in this state. The price comparison is mandated by law.

- Maintaining a toll-free telephone line for consumers with questions or complaints about insurance (installed in January 1990).

The department sends press releases on a monthly basis to the media, and department staff, particularly the commissioner, give speeches to groups and organizations. We estimate that in 1990 department management staff gave more than 100 speeches to consumer and industry groups, and conducted approximately 44 media interviews. Also, the department is represented on the newly-developed South Carolina Consumer Education Council.

The department could better advertise its services. For example, the toll-free number is not widely advertised, nor is it listed in the telephone book. The department has no print or visual advertisements, nor has it produced any public service announcements, advertising the toll-free number and other services to consumers.

The shopper's guides are distributed primarily from the department's offices in Columbia. Thus, they are available mostly to consumers who actually visit the department. The department estimates that between 2,500 to 3,500 shopper's guides are given out yearly.

A major objective of the insurance commission is to "educate the public about the regulation of insurance." One aspect of this would be to inform consumers of what the department can do to help them. If the department were able to expand its system for distributing information, more consumers might be helped. Ways of actively reaching out to consumers could include:

- paid advertisements in newspapers and magazines;
- regular public service announcements;
- the assistance of other governmental agencies to facilitate information distribution; and
- distribution of information by employers, civic and homeowners associations, insurance companies, and other groups.

Evaluating Consumers' Needs

The department has not conducted formal planning to assess consumers' information and education needs, develop the methods necessary to meet these needs, and provide for the distribution of needed information. No criteria have been developed to determine what consumer education activities are most needed, or for what lines of insurance. While the commissioner and staff give presentations and speeches to various groups, there is no plan to target the education needs of specific consumer groups. Consumer information could be more widely distributed, as discussed above.

A more comprehensive program to provide consumer education and information might include, for example, additional price comparisons for homeowners and term life insurance, or information for non-reading adults who cannot use the department's automobile shoppers' guide and price comparison.

A comprehensive plan would help the department meet its goal of educating and informing consumers about insurance. Consumer education about insurance could help prevent marketplace abuse by insurance companies and agents. In addition, a well-informed insurance consumer would be in a better position to choose between insurance products, which in turn could foster increased competition between insurance companies.

Recommendation

- 10 The department of insurance should develop a plan to assess the information and education needs of insurance consumers. This plan should also address the dissemination of information to insurance consumers.

Market Conduct Exams and Investigations

The department monitors the practices of insurance companies and agents through periodic market conduct examinations and targeted investigations. Market conduct examinations are performed on in-state companies in conjunction with financial solvency exams, which are required by law to be conducted every five years. During FY 87-88 through FY 89-90, 117 exams were conducted. The following describes our review of these exams and department investigations.

Market Conduct Exams of In-State Companies

We found inadequate documentation that the department followed established policy during reviews of the market conduct of insurance companies. Department officials stated that the NAIC *Market Conduct Examiners Handbook* is used as a policy manual for conducting market conduct exams. According to this handbook, insurance departments should review insurance companies' practices in areas such as sales and advertising, underwriting policies, rate application, claims processing, and complaint processing to determine the company's overall treatment of policyholders.

We reviewed a judgmental sample of department working papers for five insurance companies examined by the department from 1988 to April 1990. We found that the department had not reviewed insurance companies' handling of consumer complaints, canceled policies, and nonrenewed policies in any of these exams. Also, there was no universal review of insurance companies' underwriting and rating procedures. Due to its limited size, this sample may not have been statistically representative of all market conduct examinations; however, officials of the department stated that the market conduct exams conducted prior to 1990 were less thorough than those currently conducted.

In May 1990, prior to the beginning of our audit, the department began placing a greater emphasis on market conduct exams and began formulating checklists listing general areas of review, in addition to using the NAIC handbook, to ensure better uniformity. As evidenced by one recent report and verified by department officials, a new method of reporting the results of the market conduct exam has also been implemented. Department officials stated that the final written financial examination will now include a separate section covering just market conduct issues. The department, however, has not developed any written procedures specific to South Carolina's laws and regulations as suggested by the NAIC.

A thorough and uniform market conduct examination of each in-state insurance company will help detect market conduct violations and provide the department with a more effective method of preventing potential harm to insurance consumers.

Market Conduct Exams of Out-of-State Companies

The department is required only to conduct examinations of in-state companies, which represent 15.8% of the premiums written in South Carolina. The department conducts no independent market conduct examinations of out-of-state companies to determine the manner in which South Carolina policyholders are being treated. The department depends on exams conducted by other states and has reviewed, in conjunction with these states, the market conduct of several companies outside of South Carolina.

The department compiles a listing of insurance companies which received 12 or more complaints during a year and whose market share of complaints exceeded their market share of premiums. However, the department does not use this information to initiate any examinations to further determine problem areas or initiate corrective action.

Our survey of eight southeastern states found that five states conduct some form of market conduct exams in response to complaint data. South Carolina currently reviews market conduct issues for in-state companies; however, the department could use the complaint data currently collected, as well as other pertinent data, to establish criteria to identify out-of-state companies in need of market conduct examinations. Targeted market conduct exams of out-of-state companies would help to ensure that all policyholders in South Carolina are protected against possible market conduct violations.

Recommendations

- 11 The department should conduct a thorough and consistent market conduct examination in conjunction with each financial condition examination on all in-state companies.
- 12 Using the NAIC *Market Conduct Examiner's Handbook* as a guide, the department should establish written procedures specific to South Carolina outlining the steps the examiners should complete for all market conduct examinations.

- 13 The department should establish written procedures for documenting and reporting market conduct examinations.
- 14 The department should conduct targeted market conduct examinations on out-of-state companies which demonstrate a need for review, based on criteria established by the department.

Investigation of Insurance Violations

Insurance laws prohibit certain kinds of marketplace conduct and policyholder treatment such as unfair trade and improper claims practices, misrepresentation of policies and benefits, fraudulent sales activities, failure to remit premium money, and selling insurance without a license. When an individual or company is suspected of violating insurance statutes, a four-person investigation section, in coordination with the legal division, investigates. From January 1987 through December 1989, the department performed 240 field investigations. In 1990, an additional 217 investigations were conducted.

We reviewed a statistically representative sample of 56 files from 1987 to 1989 to determine how the department conducted and documented investigations. Of these, one file could not be located and four cases were still open. Five of the completed investigations were open for more than one year, and the average length of time taken to investigate a case was 132 days. Seventy-seven percent of the investigations reviewed concerned allegations of agent wrong-doing; the remainder related to insurance companies and other licensed entities.

When investigators find sufficient evidence of wrong-doing the department can either revoke or suspend an insurance license or levy an administrative fine. Department records show that 1,128 separate disciplinary actions were taken against insurance companies and licensees from FY 87-88 through FY 89-90.

According to department staff, the number of disciplinary actions increased in FY 88-89 as a result of a department program to conduct criminal background checks on all licensed individuals. Agents who were found to have been convicted of crimes of moral turpitude had their licenses suspended or revoked. A field investigation is not always needed before the department can invoke administrative sanctions against a licensee.

In our review, we found no problems with the way investigations were conducted and documented, and that the department was pursuing

administrative action against those individuals and companies found in violation of insurance laws. However, the department has no written guidelines for referring cases to the appropriate authorities when criminal violations of state laws are involved.

Reporting of Possible Criminal Violations

We found that the department did not routinely report possible criminal violations of state law to solicitors. Section 38-3-110 of the South Carolina Code of Laws states that the commissioner is to "report to the Attorney General or other appropriate law enforcement officials criminal violations of the laws relative to the business of insurance or the provisions of this title which he considers necessary to report . . ." In 1983 the Attorney General instructed the department to refer criminal prosecutions to the appropriate solicitor. However, the department lacks guidelines to determine when it should pursue criminal prosecution of agents who have violated insurance laws.

We reviewed 23 cases occurring in 1990 where the department revoked the licenses of insurance agents. All of these cases involved fraud, misappropriation of funds or failure to account for premium collections, involving a total of approximately \$387,300 in policyholder and insurance company funds. Five of these cases had been reported to state solicitors or law enforcement agencies. In one case the complainant pursued civil litigation.

Most of the remaining 17 cases were not referred because the department believed that criminal intent would have been difficult to prove, or because the agent involved had agreed to make restitution. We found several cases, however, that might have warranted review by the appropriate solicitor because of the nature of the violation involved. For example:

- An agent had his license revoked for submitting fictitious applications for insurance to an insurance company solely to obtain approximately \$2,800 in commissions.
- An agent had his license revoked for improperly retaining premiums amounting to \$15,813, instead of remitting them to the insurance company.
- An agent had his license revoked for transacting business for an unlicensed insurance agency, for securing cash advances from proposed

insurance consumers by fraudulent statements, and for engaging in unfair and deceptive trade practices.

Section 38-43-240 states:

any agent . . . who secures cash advances by false statements or . . . fails to turn over when required or satisfactorily account for all collections is guilty of a misdemeanor and, upon conviction, must be fined or imprisoned, in the discretion of the court.

In addition, §38-43-245 makes submitting fraudulent insurance applications a felony.

Without guidelines, insurance crimes which merit prosecution might not be prosecuted. Since it did not refer these cases to the solicitors' office, the department has no way of knowing if the solicitors would have been interested in pursuing criminal convictions. Guidelines which set certain prosecutorial standards, such as amount of money involved, would help the department determine which cases it should report. In addition, it is not clear why an agreement to make restitution would preclude forwarding a case to the solicitor.

Recommendation

-
- 15 The department, in conjunction with solicitors, should develop guidelines for determining what cases involving violations of insurance laws should be referred for possible criminal prosecution.
-

Company and Agent Licensure

Another mechanism the department uses to protect consumers is licensing companies and agents. Those licensed must meet minimum competency and financial requirements to protect policyholders. The following section discusses the licensure process.

Company Licensure

State law requires that, with few exceptions, every insurance company doing business in South Carolina be licensed and supervised by the department. The minimum requirements for company licensure are established in state laws and regulations. The insurer is required to maintain adequate reserves to protect the policyholders of this state, and to have directors and officers who are competent and trustworthy with a good business reputation.

The department licensed 168 new insurers during the years 1987, 1988 and 1989. We reviewed the department's internal controls for ensuring that the licensure process was conducted in a consistent and thorough manner. As part of this review, we analyzed a random sample of records for 51 of these 168 companies and interviewed department personnel.

During our review, we found that the department has an outline of general qualifying requirements and application procedure in its application packet; however, the department does not have a written policies and procedures for evaluating these applications regarding whether or not to license the insurance company. For example, the department does not have written procedures to document how the various factors considered for licensure are evaluated.

Section 1-23-140 of the South Carolina Code of Laws requires that agencies have written policies available to the public. Written procedures will increase the likelihood that applicants for company licensure will be reviewed and considered consistently.

Recommendation

-
- 16 The department should develop written policies and procedures for determining whether to license insurance companies.
-

Agent Licensure

State law requires that all insurance agents, adjusters, motor vehicle damage appraisers, brokers, and bailbondsmen be licensed. As of December 1990, there were 35,167 active agents, 3,373 adjusters and 870 appraisers licensed in South Carolina. Brokers licenses also were held by 1,313 agents. In addition, the department keeps track of approximately 30,000 inactive agents, who can retain their credentials for two years before they are dropped from the department's records.

Before qualifying for licensure, agents must meet several criteria. They must complete 40 classroom hours in an approved pre-licensing course or have the equivalent of one year's experience, and pass the department exam. In addition, an agent must first be appointed as a representative of at least one insurance company, and the company must furnish the department a State Law Enforcement Division criminal background check showing whether the applicant has a criminal history.

For every company an agent represents, he or she holds a separate license; thus, the 35,167 individual agents and brokers hold a total of about 138,046 licenses. The department keeps track of these licenses through an on-line computer system.

Agents who are residents in 48 other states are granted licenses in South Carolina on a reciprocal basis. The department recognizes reciprocity with every state except Wyoming. (Wyoming does not allow nonresident agents.)

We examined a statistically representative sample of 72 files for individuals licensed in 1990 to determine if the files contained the required information. No material problems were found.

Licensing Exam

All insurance agents as well as adjusters and appraisers are required to pass a 100-question exam. There are 18 different exams for life, accident and health insurance, property and casualty insurance, and adjusters and appraisers. (Agents who sell credit life or credit accident and health insurance only are exempt from the exam requirement.) The exam questions were developed internally by the department, drawing on the technical expertise of staff from several divisions. In 1990 a total of 7,202 exams were administered.

Also, the department approves insurance course materials and curriculum for the required 40-hour pre-certification course. Curriculum guidelines were developed by the department through an ad hoc committee which included members of the industry and department staff. These courses are taught by technical colleges, proprietary or correspondence schools, and some insurance companies.

In 1985, we recommended that the department use a professional testing service to help develop the insurance exam. This has not been done. While the exam is no longer the sole measure of agent competency required by the

department, external review by a professional testing service would help ensure the reliability, objectivity, and validity of the exam.

Recommendation

- 17 The department should consider using a professional testing service to provide external advice and review for the license exams.
-

Continuing Education

The department is supporting legislation that would require all agents, both active and inactive, to complete 24 hours of continuing insurance education (CIE) every two years. Our 1985 review of the department also recommended that the General Assembly consider legislation to require CIE. Since that time insurance has become a more complex and complicated product, with ever-changing statutory and market conduct requirements. Consumers depend on insurance agents to be well-informed and knowledgeable about the insurance coverage they are selling. Continuing education would help improve the competency of insurance agents.

Recommendation

- 18 The General Assembly may wish to consider enacting legislation to require continuing education for insurance agents.

Insurance Company Solvency Regulation

The department's financial condition division is responsible for detecting potential problems which may affect the financial soundness of any company licensed to conduct business in South Carolina. It primarily uses three methods to uncover problems. First, the division receives notices from the National Association of Insurance Commissioners (NAIC), warning of companies which may be facing solvency problems. Second, the division analyzes companies' annual financial statements. Another method used includes examinations (audits) conducted by the department of companies domiciled in South Carolina.

Two sections, the analysis section and examination section, conduct these functions. We reviewed the department's methods for regulating companies for solvency and the action taken when financially unsound companies are detected. This chapter discusses methods which could improve solvency regulation and better detect financially unsound insurance companies before they face insolvency.

Analyzing Company Financial Information

The analysis section routinely analyzes insurance company financial reports to detect potential solvency problems and noncompliance with state laws. However, the department has not developed a comprehensive written strategy for analyzing these reports, and it has no written criteria for evaluating information gathered during analysis. Further, there is no formal system for managers to review analysts' decisions to determine if they are correct.

Analysts prepare a checklist for each company's financial report. The analyst evaluates the checklist information, decides if further analysis of the financial report is warranted, and indicates his decision on the checklist. If the analyst decides that no further analysis is needed, the process ends. If further analysis is needed, the analyst completes additional worksheets to determine if any department intervention is necessary.

Some of the department's evaluation criteria are derived from the NAIC Insurance Regulatory Information System (IRIS). However, most of the department's criteria for evaluation are not in writing.

If the analyst decides that further analysis is not needed, that decision is not likely to be reviewed. There is no procedure for either routine supervisory or co-worker review of the analyst's work. We sampled 129 analyses performed from January 1, 1988, through December 31, 1990, to evaluate

the quality of the analysis and compliance with written procedures. We noted six instances where the analyst had not indicated a decision on the checklist. Further analysis was not done in these cases, but we could not determine if it should have been. We also noted 13 instances where the analyst had indicated the need for further analysis, yet the additional worksheets were not completed.

All four of the analysts (including the chief analyst) at the department are senior level. The chief analyst and two of the analysts have been with the section since at least 1976. The chief analyst has stated that he relies heavily on the analysts' experience to detect problems and areas of concern.

Lack of a comprehensive written strategy and written analysis criteria could result in inconsistent analysis conclusions, and solvency problems may go unnoticed. In addition, without a written strategy and criteria for conducting financial analysis there is no formal mechanism for determining if insurance companies are in compliance with state law. Training new analysts would be more complicated, and changes to evaluation criteria may not be communicated to all analysts. Also, planned automation of the analysis process will be hindered.

Recommendations

-
- 19 The department should develop a comprehensive written plan for analyzing insurer financial statements.
 - 20 The department should develop written criteria for evaluating that information, including the relative importance each factor has to the decision.

Automation of Financial Condition Analysis

Better use of automation could help increase the productivity and effectiveness of the financial analysis section. Of the 1,336 companies which were licensed during calendar years 1987, 1988, and 1989, 866 had not been subjected to an in-depth analysis during this period. The department assigns priority for in-depth analysis to certain companies. Analysts complete a basic checklist for all companies. Analysts then complete an in-depth analysis of the priority companies and any companies for which the checklists indicate the need.

The department currently has only four analysts to accomplish these functions, primarily without the aid of computer support. The number of statements to be analyzed and the limited staff dictate the need to prioritize the companies. However, all of the financial reports submitted to the department should be subjected to as much scrutiny as possible so that potential financial problems may be detected early.

The department purchased personal computers for the analysts in 1989. Some of the basic checklists are now being prepared on the computer, but the data is entered manually. Insurer financial reports are available in machine readable form, but the department has not been able to use this data due to technical problems which it is working to solve. The full advantages of automation will not be realized until the data can be transferred electronically, and more of the information available in the reports can be incorporated into the analysis process.

Recommendation

-
- 21 The department should further automate the financial condition analysis section so that the depth of analysis for all companies can be increased.

Examining Solvency of South Carolina Companies

The examination section of the department conducts examinations (audits) of the records of insurance companies, health maintenance organizations, and various other insurance entities primarily headquartered in this state. Financial condition examinations, mandated by state law, are intended as a means of detecting insurers in financial trouble as well as developing information for additional department action.

The department conducts financial condition examinations according to NAIC standards, department policy, and state law. The NAIC standards include procedures for examining the various balance sheet accounts found in typical insurance company annual statements. The standards also contain guidelines for planning the examination and for documenting the work performed. However, based on a review of selected examination working papers and discussions with department staff, the department may not be adequately planning and documenting solvency examinations.

We selected five examinations conducted from July 1, 1987, through June 30, 1990, to evaluate the department's compliance with the applicable standards. During this period, the department conducted 117 examinations, including participation in 3 examinations of companies not headquartered in this state. Our sample was selected judgmentally, and may not be representative of all examinations performed during this time.

We compared the examination planning documents and working papers to the applicable standards. Based on this review and discussions with department staff, we found that the NAIC recommended planning forms were generally not completed properly and written examination plans were not developed. We also noted, from discussions with the examiners who performed the work, that some NAIC recommended procedures were performed, but the results were not documented in the working papers.

Department policy requires written examination plans, and the NAIC's *Financial Condition Examiner's Handbook* also recommends written plans because they form the basis for monitoring the progress of the examination. The NAIC handbook further states that documentation should be maintained to provide a record of the work done, conclusions drawn, and supporting data gathered. However, neither the NAIC handbook nor the department's policy clearly define acceptable working paper documentation. There is no requirement that examination plans be referenced to the documentation of the work performed.

The lack of written plans with clear references to the documentation of work performed reduces the assurance that examinations are conducted thoroughly and consistently. Violations of law may go undetected, and potential solvency problems could be overlooked.

The examination section is aware of these problems and has issued a directive to all examiners that the NAIC planning forms be properly completed. During our review, the chief financial examiner was studying the use of written examination plans.

Recommendations

- 22 The examination section should develop written work plans for each examination. These plans should be based on the procedures recommended by the NAIC, South Carolina law, and the individual conditions of the insurer under examination.
- 23 The examination section should develop written working paper documentation standards. These standards should include procedures to link the work performed directly to the examination plan.

Regulation of Financially Unsound Insurers

The department may place a financially unsound in-state company or out-of-country company, which is domiciled in this state, in rehabilitation or liquidation. The department may also place an in-state company under supervision. When a company is placed under supervision, the department notifies the company of what problems need to be corrected and the company is given a certain amount of time in which to comply. If a company is placed in rehabilitation, the department is trying to reform and revitalize the insurer. When a company is placed in liquidation, the department takes over the assets of the insurer and administers them under the general supervision of the court. There were no companies placed under supervision or rehabilitation from January 1988 through December 1990; however, two in-state companies were placed in liquidation.

The department does not have the authority to place out-of-state companies under supervision, rehabilitation, or liquidation but does monitor their financial solvency (see p. 33).

For both in-state and out-of-state companies licensed in South Carolina, the department may determine that disciplinary action is needed and suspend or revoke a company's license. Suspensions and revocations may help to eliminate possible financial harm to the public or policyholders.

We found the following area in need of improvement.

Written Procedures

The department has limited written procedures and checklists for regulating companies which are in financial trouble; however, the department does not have a comprehensive written policies and procedures manual. For example, the department does not have a policy outlining the process by which the department determines if a company meets the criteria described in the law for implementing actions such as suspensions and revocations.

The development of policies is required by §1-23-140 of the South Carolina Code of Laws. Also, written policies will help to ensure uniformity in the application of state law.

Recommendation

-
- 24 The department should develop written policies and procedures for ensuring that state laws pertaining to regulating and disciplining financially unsound companies are uniformly enforced.

Sunset Issues

This chapter addresses the eight sunset issues which we are required by law to address.

Issue (1) Effects of Regulation

Determine the amount of the increase or reduction of costs of goods and services caused by the regulations promulgated by and the administering of the programs or functions of the agency under review.

According to the insurance department, in 1989 South Carolina consumers paid approximately \$4.5 billion in insurance premiums. We did not attempt to quantify the effect of regulations and programs of the insurance department on insurance rates, due to the complexity of such a task. However, we can indicate the potential effect of various aspects of insurance regulation on rates:

- Total taxes and fees paid by the insurance industry in South Carolina were \$102.3 million in FY 88-89. The extent to which these costs are passed on to consumers is not clear. If all of the costs were passed on, they would comprise approximately 2% of insurance premiums.
- Insurance companies and professionals are required to be licensed by the department. Licensed companies must meet requirements including minimum levels of capital and surplus. Limiting the supply of companies may contribute to higher insurance rates but may also prevent company insolvencies. Licensed professionals must meet requirements including minimum scores on standardized tests. Limiting the supply of insurance professionals may also contribute to higher insurance rates but provides a check on incompetence and misconduct.
- Rates for certain lines of insurance are regulated by the department. We did not analyze the effect of rate regulation on insurance rates in South Carolina. However, studies comparing the effects of different systems across the country have found that rate regulation may have no effect in certain instances but may reduce rates in others. It is important to note, however, that the reduction of rates below those which would have been produced by competition can be accompanied by negative side effects.

- State law prohibits insurance agents from discounting insurance rates by sharing their commissions with consumers. This prohibition may reduce competition in some instances, resulting in higher rates.
- The department provides consumer information to the public. Increased levels of consumer information can contribute to increased competition within an industry. Increased competition can contribute to lower rates than would otherwise occur.
- The cumulative effect of all regulation of the insurance industry by the department increases insurance company expenses. Independent of other effects of regulation, increased insurance company expenses may contribute to higher rates.

Issue (2) Impacts of Deregulation

Determine the economic, fiscal, and other impacts that would occur in the absence of the regulations promulgated by and the administering of the programs or functions of the agency under review.

Insurance companies have a partial exemption from federal antitrust laws if a state regulates insurance. The South Carolina Department of Insurance regulates solvency, insurance rates, and market conduct (including unfair sales, advertising and underwriting) practices. Below are additional effects which could result from state deregulation:

Solvency Regulation

The department requires insurance companies to have a certain amount of capital and surplus funds and to meet other solvency related standards in order to conduct business in South Carolina. The number of financially unsound insurance companies could increase if the department did not require companies to be financially sound. If more companies became insolvent, there could be insufficient funds to pay claims.

Although solvency is currently regulated at the state level, the possibility of regulating solvency at the federal level has been raised. The department's role in regulating insurance solvency is discussed in Chapter 4.

Rate Regulation

South Carolina law requires insurance companies to receive department approval before using rates for certain lines of insurance. Some states do not regulate rates while other states have a lesser degree of rate regulation than South Carolina. Studies have shown that state rate regulation in some cases has had no effect on the cost of insurance, but in other cases has lowered the cost of insurance. However, there can be negative side effects from rate regulation. Rate regulation and its implications are discussed in Chapter 2.

Market Conduct Regulation

Without regulation of deceptive and misleading trade practices, policyholders could be left without protection from an industry with a significant economic impact offering a complex product. Many consumers lack the expertise to judge insurance companies' sales practices, the value of alternative types of insurance, and the policies offered to them.

Issue (3) Administrative Costs

Determine the overall costs, including manpower, of the agency under review.

The department's expenditures increased approximately 25% over the past 5 years, from \$4,460,040 in FY 86-87 to an estimated \$5,586,020 in FY 90-91 (see Table 5.1). In FY 90-91, the department had 119 authorized positions.

The department is primarily funded through annual appropriations from the General Assembly. The department collects revenue, including taxes and fees, from the insurance industry of which a portion is retained by the department, a portion is distributed to political subdivisions and the remainder is deposited in the state's general fund (see Table 5.1). Total revenue for FY 86-87 was \$96,805,360 and for FY 90-91 was estimated to be \$107,786,000. This is an increase of approximately 11%.

Table 5.1: Source of Appropriations, Revenues, and Expenditures

	FY 86-87	FY 87-88	FY 88-89	FY 89-90	FY 90-91 ^a
Revenues					
Total	\$96,805,360	\$96,043,316	\$102,267,731	\$103,921,979	\$107,786,000
Expenditures					
Personal Services	\$2,685,724	\$2,676,121	\$2,828,043	\$3,080,522	\$3,303,240
Debt Services	40,500	40,500	40,500	40,500	20,250
Employee Fringe Benefits	506,801	502,800	523,564	624,508	762,705
Other	1,227,015	1,184,603	1,349,265	1,505,437	1,499,825
Total	\$4,460,040	\$4,404,024	\$4,741,372	\$5,250,967	\$5,586,020
Appropriations	\$4,800,194	\$4,584,767	\$4,864,157	\$5,377,169	\$5,477,427

^aEstimated.

State appropriation act provisos for FY 87-88 through FY 89-90 require that professional and occupational licensing agencies generate revenue equal to 115% of appropriations. The FY 90-91 state appropriation act proviso requires that revenue amount to 110% of appropriations. From FY 87-88 to FY 90-91, the department's revenues ranged from 1,933% to 2,103% of appropriations, thus exceeding the requirements of the appropriation act provisos.

Issue (4) Efficiency of Administration

Evaluate the efficiency of the administration of the programs or functions of the agency under review.

During the course of our review, we noted two general areas in which improvements relating to efficiency could be made.

Written Procedures

In several of the department functions we reviewed, there is a need for more written and more specific policies and procedures to guide department operations. By ensuring that its operations are guided by written procedures, the department would have greater assurance that its activities are conducted consistently and thoroughly (see pp. 5, 20, and 38).

Data Processing

Although not an objective of our review, we noted that the department has a need for more data processing resources. The department's computer system and equipment were installed in 1981 and have limited capabilities. Below are examples of areas where improvements can be made:

- Better use of automation could help increase the productivity and effectiveness of the financial analysis section. During 1987 through 1989, more than 800 companies may not have undergone an in-depth review in the past three years. This was due in part because the division does not have an automated system to analyze their financial reports (see p. 35).
- The department uses a national insurance database to obtain information about out-of-state agents seeking a South Carolina license. This database tells the department if the applicant was the subject of disciplinary actions in other states. However, because it lacks the personal computers necessary to communicate with this database, the department must access the information through the mail. This means a one- to two-week wait before the department can obtain certain information about applicants.

- The department does not computerize the names of applicants who have tried to obtain South Carolina licenses but were denied because they failed to meet statutory requirements, such as the absence of a criminal record. Applicants denied a license are not permitted to re-apply for two years. However, without the capability to store this information on computer, it is difficult for the department to screen new applicants to see if they had previously been denied licensure.
- The department does not have the data processing capability to keep track of more than 143,000 license renewals. Rather, this is done manually, which makes the process more cumbersome.

The department has addressed some of these and other data processing needs in its FY 91-92 Information Technology (IT) Plan.

Recommendation

- 25 The department should continue to seek expanded and upgraded computer processing capabilities to improve the efficiency of its operations.

Issue (5) Public Participation

Determine the extent to which the agency under review has encouraged the participation of the public and, if applicable, the industry it regulates.

Members of the public and the insurance industry are given opportunities to participate in insurance regulation. Meetings of the Insurance Commission are public and schedules of the meetings are published annually. The Insurance Commission is composed of seven members who are appointed by the Governor with the advice and consent of the Senate. All members must be selected from the general public and are barred from having employment in the insurance industry during the four years immediately preceding appointment. The Chief Insurance Commissioner is hired by the commission.

The governor also appoints an advisory committee to assist the commission. The advisory committee consists of five industry representatives: one each from the life insurance field, the property and casualty insurance field and the accident and health insurance field; one property and casualty agent; and one life, accident, and health agent.

The department by law must notify the public of certain rate hearings through the news media 30 days in advance. Rate hearings for property and casualty insurance must be held when the company requesting the rate increase has earned more than \$500,000 in premiums in South Carolina in the previous year for a particular line or type of insurance. The Consumer Advocate of the South Carolina Department of Consumer Affairs participates in rate hearings and represents the consumers' interest. The Department of Consumer Affairs also monitors insurance legislative developments.

The Columbia, Greenville, and Charleston telephone books do not list the toll-free consumer number for the department. This is discussed further on page 23.

Issue (6) Duplication of Services

Determine the extent to which the agency duplicates the services, functions and programs administered by any other state, federal, or other agency or entity.

The South Carolina Department of Insurance is the only state agency responsible for regulating the insurance industry. The federal government has not regulated the insurance industry. Congress has delegated the authority to regulate and tax the insurance industry to the states.

The department regulates the industry and assesses fees and taxes on licensees. The South Carolina Tax Commission also collects taxes, but does not collect taxes for the department of insurance. We could find no duplication of functions among state, federal, or local government entities.

Issue (7) Handling of Complaints

Evaluate the efficiency with which formal complaints, filed with the agency concerning persons or industries subject to the regulation and administration of the agency under review, have been processed.

From 1987 through 1990, the department received about 19,750 written complaints. We sampled three years of complaints and reviewed department statistical data. Based on our review, we concluded that the department needs to develop more specific guidelines for helping consumers with complaints. The department lacks comprehensive procedures for documenting and processing complaint files. In addition, we found that the department could be gathering more specific data on the nature and sources of consumer complaints.

Our evaluation of how the department handles consumer complaints is on page 19.

Issue (8) Compliance With the Law

Determine the extent to which the agency under review has complied with all applicable state, federal, and local statutes and regulations.

The regulation of insurance is governed by state statute. Insurance laws cover more than 800 pages in the South Carolina Code of Laws and are revised yearly by legislative action. We did not review department compliance with each individual section of the insurance laws. Instead, we focused on reviewing some of the major internal controls which the department has in place to ensure compliance with laws.

Insurance in South Carolina today is a \$4.5 billion business involving more than 1,400 licensed companies and 40,000 licensed individuals. Well-defined management and enforcement systems allow the department to use limited resources to effectively monitor the insurance industry.

We examined the systems used by the department to carry out its four main regulatory responsibilities: ensuring the solvency of insurance companies; approving rates and forms; regulating the conduct of the industry in the marketplace; and ensuring that insurance agents and companies meet statutory requirements for licensure.

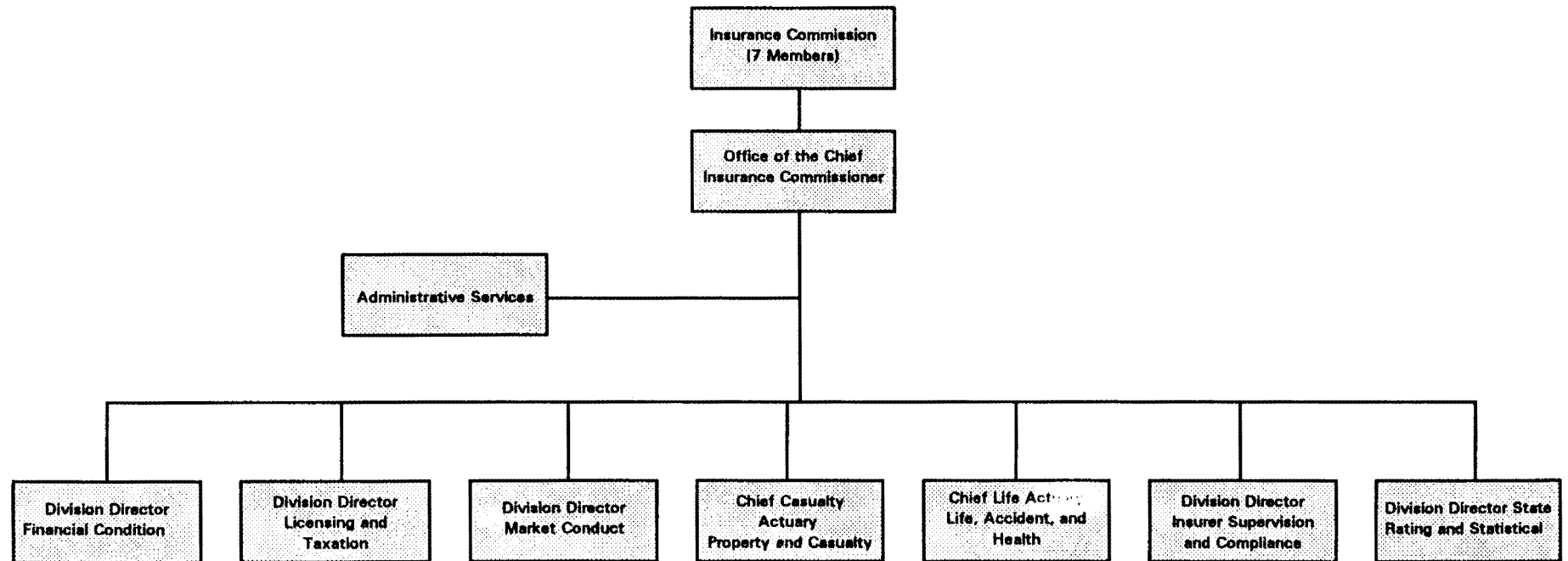
We found that the department needs more specific standards and written policies and procedures in order to better monitor and enforce statutory requirements. Chapters 2, 3, and 4 of the report deal with this issue in depth.

Chapter 5
Sunset Issues

Appendices

Appendices

South Carolina Department of Insurance Organization Chart



Source: Department of Insurance.

Rates, Rules, and Forms For Which Approval of the Department is Required

State law requires that the insurance department approve rates and forms for most lines of property and casualty insurance before companies may use them. Prior approval of rates is not required for reinsurance, ocean marine, certain lines of inland marine, aircraft, and surplus lines (insurance not available from licensed companies). Prior approval of forms is not required for surplus lines and surety bonds. In addition, although state law and regulation do not specifically refer to insurance rules, a department official stated that they require prior approval of rules for all property and casualty lines except surplus lines and surety bonds.

State law requires that the insurance department give prior approval of rates for all lines of individual accident and health insurance. Prior approval of group accident and health insurance rates is required for Medicare supplement insurance and mass-marketed insurance. In addition, prior approval of rates is required for HMOs and credit life and disability insurance. Prior approval of rates is not required for other categories of group accident and health insurance or other categories of life insurance. Prior approval of forms is required for all lines of life, accident, and health insurance except for group policies sold in another state.

Glossary

Accident and Health Insurance - Insurance which provides hospital, medical, surgical, and income benefits in the event of sickness, accidental injury or accidental death.

Actuary - An individual trained in the insurance field who determines premium rates, reserves, and dividends as well as conducts various other statistical studies.

Adjuster - An individual who determines the extent of insured losses and attempts to settle insurance claims.

Annuity - A contract that provides an income for a specified period of time, such as a number of years or for life.

Barriers to Entry - Financial, technological, legal, and other limitations which make it difficult for a new firm to enter an industry.

Broker - A licensed agent who represents buyers of insurance and deals with either other insurance agents or companies in arranging for insurance required by the customer.

Capital - Insurance company assets which must be maintained at all times and cannot fall below a minimum specified by law.

Casualty Insurance - Insurance concerned primarily with the insured's legal liability to others or for damage to other peoples' property; casualty insurance also encompasses such forms of insurance as burglary, robbery, and workers' compensation.

Credit Insurance - Life, disability, or property insurance bought in conjunction with a loan or other credit transaction.

Domicile - The state where the legal residence or headquarters of an insurance company is located, or from where its initial license was issued.

Franchise Insurance - A form of insurance in which individual policies are issued to employees of a common employer or the members of an association.

HMO (Health Maintenance Organization) - An organized system of health care that provides comprehensive health services for a fixed, pre-paid fee by leasing or ownership of medical facilities and agreements with hospitals and physicians.

Insolvency or Insolvent - When an insurance company is unable to pay its obligations when they are due, or when its assets do not exceed its liabilities plus any capital and surplus required by law to be maintained.

Involuntary Market - Insurance policies that, in order to be in compliance with state law, insurance companies must sell to customers who fail to meet their underwriting standards. For auto insurance in South Carolina, this market takes the form of the reinsurance facility.

IRIS - Insurance Regulatory Information System, developed by the National Association of Insurance Commissioners (NAIC) to help detect potentially financially troubled insurers.

Liquidation - The process by which an insolvent company's assets are taken over and administered under the general supervision of the court.

Loss Ratio - An insurance company's incurred losses divided by the earned premiums.

Loss Reserves - The amount set aside by the insurance company for claims reported but not yet paid, and for claims incurred but not yet reported.

Marine Insurance - A broad type of insurance, generally covering goods in transit. Marine insurance includes both aircraft and ocean marine insurance, which provides protection for ocean-going vessels and cargo; and inland marine, which covers goods shipped inland as well as bridges, tunnels and other instrumentalities of transportation. It can include optional policies covering personal property and jewels, furs, fine arts, and other goods.

Market Concentration - The degree to which a few firms hold a share of the market.

NAIC - National Association of Insurance Commissioners. The head of each state insurance department is a member of the NAIC.

Premium Service Company - A company which finances the premium of an insurance policy for the buyer.

Premium - The payment made for an insurance policy.

Property Insurance - Insurance providing financial protection against loss or damage to real and personal property caused by fire, theft, windstorm, hail, malicious mischief, and other perils.

Rates, Rules, and Forms - Rates are insurance policy premiums, or the cost per unit of insurance. Forms are the insurance policies, contracts and related documents. Rules, in general, are instructions developed by insurance companies for determining how to implement insurance rates.

Rehabilitation - The process by which the department attempts to reform and revitalize a financially troubled insurance company.

Reinsurance - When one insurance company assumes all or part of a risk insured by another insurance company.

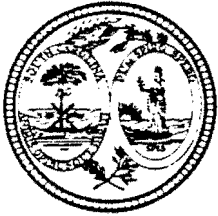
Surplus Lines - Insurance not available in the regular market from licensed companies.

Surplus - The excess of assets over liabilities, which must be maintained at a certain minimum level.

Underwriting - The process by which an insurance company decides whether or not and on what basis it will accept a risk.

Appendix C
Glossary

Agency Comments



STATE OF SOUTH CAROLINA
DEPARTMENT OF INSURANCE

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CHIEF INSURANCE COMMISSIONER

May 30, 1991

The Honorable George L. Schroeder
Director
Legislative Audit Council
400 Gervais Street
Columbia, South Carolina 29201

Dear Mr. Schroeder:

The Chairman of the South Carolina Insurance Commission and the South Carolina Department of Insurance have received and read with interest the report to the General Assembly, entitled "A Sunset Review of the South Carolina Department of Insurance," prepared in accordance with Act 108 of 1978. Since the passage of that Act, the South Carolina Department of Insurance has undergone three "Sunset Reviews" by the Legislative Audit Council. The most recent audit was commenced on July 23, 1990, and lasted some ten months. We are gratified that there were no violations of state laws by the Department of Insurance found or specified in the report.

We support and view the "Sunset Review" process as a positive management tool to assist us in more efficiently and effectively meeting our statutory and regulatory responsibilities. Our specific responses to the audit's recommendations follow:

1. The insurance department should maintain comprehensive policies and procedures manuals for analysts to use when determining whether insurance rates, rules, and forms are in compliance with all relevant state laws and regulations. Such manuals should include procedures requiring analysts to document the steps they take in reviewing rates, rules, and forms, and the rationale for all final decisions.

We agree. On March 14, 1991, a procedure was implemented in both the Life, Accident and Health Division and in the Property and Casualty Division to formally document that all relevant statutes and regulations are complied with prior to any rates, rules or forms being approved.

2. The insurance department should promulgate through state regulation all policies and procedures for which such action is required by state law.

To the extent that this recommendation suggests that the Department promulgate regulations to amplify statutory criteria for rate reviews, we will do so in those instances where it is feasible and will prove

beneficial to the public, the Department and to those entities that are required to make rate filings.

3. **The insurance department should periodically conduct on-site examinations of a limited number of in-state and out-of-state insurance organizations to test whether the specific data they have submitted in rate filings are accurate.**

We agree that public confidence in the rate approval process might be increased by conducting limited on-site examinations of rate-making data. However, this recommendation implies that the data submitted by insurance companies in support of rate requests is not verified and that is not the case. Such an implication might lead to a dangerously erroneous conclusion, and it is significant that the report states, "We received no information to indicate that rating data submitted by companies were inaccurate."

The Department employs a number of internal and external controls to ensure the credibility of data contained in insurance company rate filings. Rate-making data supplied by insurance companies in such rate filings consists, in part, of figures reflecting earned premiums, losses paid and expenses. These figures are audited by the Department in the following ways:

A. The figures contained in an insurer's annual statement, which are thereafter used or extrapolated from, in preparing rate filings, are required by law to be attested to by an officer of the company, who by that attestation verifies that the figures contained therein are accurate. Criminal penalties attach for misstating facts or figures in an annual statement.

Additionally, all annual statements are audited by financial examiners of this Department or financial examiners from other states, and we receive copies of these reports. The integrity of the data contained in the annual statement will be further corroborated effective June, 1992, when insurers will be required to file, on an annual basis, an audited statement prepared by a certified public accountant which certifies that the annual statement data is correct. Finally, the loss reserves reflected by an insurer in its annual statement are required by law to be certified annually by a member of the American Academy of Actuaries or the Casualty Actuarial Society.

B. The earned premium figures used by insurers contained in the rate filing are compared both against those reflected on page 14 of the insurer's appropriate annual statement, as well as those contained in the market share figures annually compiled by the Department. If there is an unexplained disparity, the insurer is required to provide additional supporting data.

C. The company's expenses as reflected in the rate filing must be extracted from, and are verified by reference to, the expense exhibit filed with the annual statement.

D. Best's Aggregates and Averages, a publication which categorizes company data by line of insurance as reported on an insurer's annual statement, is consulted to verify the accuracy of the insurer's earned premiums, expenses and loss ratios as shown in the rate filing.

E. The data reflected in the annual statement filed by insurers which is used in rate filings forms the basis for the corporate return of the company made to the United States Internal Revenue Service. That corporate return is sworn to by an officer of the company as being accurate, and criminal penalties attach if the return contains false information.

F. Historically, in instances in which the Consumer Advocate for South Carolina intervenes in a rate hearing, the first interrogatory from the Consumer Advocate to the insurer requests that a copy of the most recent annual statement be provided. The annual statement is then supplied to the Consumer Advocate's retained actuary and economist for the purpose, among other things, of comparing the data contained therein to that included in the rate filing.

G. With respect to private passenger automobile insurance rate filings, Section 38-73-465 requires insurers to file an investment income exhibit which specifically makes reference to data contained in the annual statement.

H. In instances in which public rate hearings are required by statute, the insurer's testimony regarding the data supporting the rate request is given under oath. Again, criminal penalties attach for making false statements. In the most recent State Insurance Department Resources Survey, produced by the National Association of Insurance Commissioners (NAIC) Research Library, South Carolina is listed as holding more public hearings in rate setting matters than any other state in the United States. Significantly, according to a telephone survey conducted by the Department, there are 20 states with prior approval or modified prior approval statutes. Not one of those 20 states conducts on-site audits of the data contained in rate filings as recommended by the Legislative Audit Council. We will, however, do so.

4. The insurance department should periodically conduct reviews of a limited number of in-state and out-of-state insurance companies to determine whether they are using rates, rules and forms which have been approved by the department.

We agree, and we are now doing so. The Insurance Department conducts periodic reviews of all in-state insurance companies to determine if approved rates, rules and forms are being used. If, during a financial condition/market conduct examination, or at any other time, it is discovered that unapproved rates, rules or forms are being used, the insurer is subject to disciplinary action in addition to being required to come into compliance. In a recent instance, an in-state insurer which had charged unapproved rates was required to make refunds to policyholders with interest.

A substantial number of foreign states also conduct market conduct examinations to verify that insurers are employing approved forms, rates and rules. These examinations may be performed on an independent basis or in conjunction with a regularly scheduled financial condition examination. In addition, on several occasions, separate and apart from a financial condition/market conduct examination, the Department has identified out-of-state insurers which were using unapproved forms or rates. In each instance, appropriate remedial action was taken.

5. The insurance department should conduct, on a periodic basis, formal studies of the costs and benefits of regulating insurance rates for each line of insurance sold in the state. These studies should address factors including:
 - Industry competitiveness.
 - The effectiveness and side effects of rate regulation.
 - Regulatory practices in other states.

We agree, and will do so, but we are disappointed that within the report, the Legislative Audit Council, which studied this issue in great detail, did not take the opportunity to make a substantive recommendation to the General Assembly on the subject other than that stated above. The report devotes several pages to this matter, but, unlike Recommendations 7 and 18, "goes to the well but doesn't take a drink."

6. Where the benefits of requiring prior approval of rates cannot be shown to outweigh the costs, the department should recommend that the General Assembly institute a less restrictive form of regulation or permit competition to regulate rates.

We agree and have done so. Now pending before the General Assembly is a proposal to adopt an "Index File and Use Rating System" for private passenger automobile insurance. That legislation has been endorsed by both the South Carolina Department of Insurance and the Consumer Advocate's Office. Also, the Department, in conjunction with the Consumer Advocate's Office, endorsed legislation in 1989, which has since been enacted into law which permits certain accident and health insurers to submit rate filings based on the "guaranteed loss ratio" criterion. Additionally, in 1989, the South Carolina Department of Insurance drafted, on behalf of the Governor's Office, and endorsed the adoption of legislation which has since been enacted which instituted the "pure loss component" and "expense component" system for property and casualty filings submitted by licensed rating organizations.

7. The General Assembly may wish to consider amending state law to permit all insurance agents to rebate or otherwise share with their customers any portion of the commissions they receive from insurance companies.

The General Assembly has dealt with this issue a number of times in the last several years and has continually rejected legislation introduced, which, if enacted, would repeal the "anti-rebate" statutes now in existence.

8. The department should update its written policies and procedures for complaint handling.

We agree, and this recommendation is currently being implemented. On December 7, 1990, a system was instituted to fully document complaint files referred to the Investigations Section. Additionally, on May 15, 1991, a system was implemented formally requiring documentation of supervisor's review over the decisions made by Consumer Assistants prior to complaint files being closed.

9. The department should consider using or adapting the 1988 NAIC complaint recording format when it next upgrades its computer processing capabilities for the market conduct division.

We agree, and have made the necessary arrangements to implement the NAIC's new "state of the art" consumer complaint recording format which is anticipated to be ready for testing in October of 1991. We intend to be "on-line" with the NAIC's nationwide database on January 1, 1992. The South Carolina Department of Insurance will be among the first states to utilize this database for compiling and sharing consumer complaint information.

10. The department of insurance should develop a plan to assess the information and education needs of insurance consumers. This plan should also address the dissemination of information to insurance consumers.

We agree. On December 11, 1990, the Consumer Insurance Interest Group (CIIG), whose chairperson is Mrs. Esther Peterson, which is composed of representatives of the Consumer Federation of America, Public Citizen and the National Insurance Consumer Organization released a report jointly prepared by the CIIG, the National Association of Professional Insurance Agents (PIA), the American Insurance Association (AIA) and the American Council of Life Insurance (ACLI). That report, entitled The Consumer Services of State Insurance Departments: An Evaluation, defined 26 specific criteria against which state insurance departments were evaluated. These criteria relate to the functions, staffing, consumer access to services, consumer information, consumer education and complaint handling. Only 8 states ranked stronger in these areas than the South Carolina Department of Insurance. Our goal is to do better.

11. The department should conduct a thorough and consistent market conduct examination in conjunction with each financial condition examination on all in-state companies.

We agree and have been doing so. On May 23, 1990, all financial examiners were notified to become familiar with the MARKET CONDUCT HANDBOOK (NAIC MODEL MARKET CONDUCT EXAMINATION HANDBOOK and the RATING AND STATISTICAL ORGANIZATION EXAMINATION HANDBOOK) and to begin the process of completing market conduct examinations on all future examinations on all in-state companies. Examinations commenced after May 23, 1990, have included thorough and consistent market conduct examinations. The NAIC HANDBOOK contains all pertinent information about scheduling, coordinating and conducting a market conduct

examination. In addition, we currently have two Certified Insurance Examiners (Market Conduct) on staff. It is the responsibility of these two individuals to ensure that all members of the examination staff comply with established guidelines.

12. Using the NAIC Market Conduct Examiner's Handbook as a guide, the department should establish written procedures specific to South Carolina outlining the steps the examiners should complete for all market conduct examinations.

We agree to do so, although we feel that this requirement is redundant since we already make use of the NAIC Market Conduct Examiner's Handbook. Nevertheless, we will establish written procedures specific to South Carolina outlining the steps our examiners should complete for all market conduct examinations.

13. The department should establish written procedures for documenting and reporting market conduct examinations.

We agree, and since May 23, 1990, the results of all market conduct examinations have been clearly documented and can be found along with the financial examination results in our most recently completed Reports on Examination. South Carolina follows the same procedure as do many other states in combining the financial and market conduct examination reports since there exists a direct correlation between the objectives of the financial and market conduct audits. However, we will reduce our current procedures pertaining to market conduct reports to a written procedures manual.

14. The department should conduct targeted market conduct examinations on out-of-state companies which demonstrate a need for review, based on criteria established by the department.

We agree. Using the NAIC Market Conduct Examiner's Handbook and South Carolina Laws and Regulations, this Department will establish specific criteria which will be used to "trigger" a market conduct examination of an insurer. Our procedures will allow for an audit to be conducted at any time with or without notice to the insurer.

15. The department, in conjunction with solicitors, should develop guidelines for determining what cases involving violations of insurance laws should be referred for possible criminal prosecution.

We agree in part and disagree in part. Although the Department's Legal Division has not "routinely reported" possible criminal violation of State law to local law enforcement officials, it has always routinely reviewed each administrative disciplinary file to determine whether or not such a referral should be made. This routine review has included a variety of factors: the ability to prove a violation of a specific criminal law, the ability to prove the intent necessary to obtain a conviction, the willingness of the specific law enforcement officer to initiate criminal action, and the willingness of any necessary witness to present testimony during a criminal court case. On March 18, 1991, a formal internal procedure was established to document the fact that each

administrative disciplinary file was reviewed with law enforcement referral in mind. The detailed procedure includes a monthly audit of selected files by the General Counsel.

The development of formal guidelines to determine which violations to report presents a different problem. Section 38-3-110(4) does not mandate that each case, or that each case which involves a certain dollar amount, be automatically referred. Rather, it allows the Commissioner the discretion to refer violations of insurance laws "which he considers necessary to report" to appropriate law enforcement officials. To fashion a rule, for example, that all violations which involve more than \$2,000.00 must be referred would result in the referral of a contract dispute over \$2,000.00 between an agent and an insurer while, under the same guidelines, the theft of \$100.00 in industrial life premiums by an agent would not be referred. Set guidelines and formal rules would clearly violate the legislative intent within Section 38-3-110(4).

Over the years, the referral process has been further complicated by the fact that local law enforcement officials are reluctant to investigate and prosecute hard-to-prove, minor white collar criminal violations. To "routinely report" cases might naturally lead to some local law enforcement officials not carefully reviewing those select violations which the Commissioner, through the Legal Division, has found "necessary to report." We do not want to be perceived as "crying wolf" and lose the importance we attach to those selected referrals which we believe should be vigorously prosecuted. On, January 15, 1991, the Department's General Counsel individually wrote each State Circuit Solicitor requesting guidelines for the format of future referrals. Four months have elapsed since that mailing and only seven circuit solicitors have responded. Nevertheless, the Legal Division will continue to attempt to develop workable formal referral guidelines.

16. The department should develop written policies and procedures for determining whether to license insurance companies.

We agree, and we will establish written procedures to document how various factors are used and considered by this Department in the company licensure process even though no exceptions were noted by the Legislative Audit Council in the review of 51 out of 168 companies licensed during 1987, 1988 and 1989. This Department has always used a consistent review by the Company Application's Committee, composed of senior staff members, to ensure that the minimum requirements established by state laws and regulations are complied with in the review of each applicant's file.

17. The department should consider using a professional testing service to provide external advice and review for the license exams.

The Department has and will continue to consider using a professional testing service to provide "external advice and review" for the license exams. In the past, the Department has been approached by a number of these professional testing services who not only want to administer the examinations, but also want to have the South Carolina Department of Insurance formally and publicly endorse their study manuals as "the manual from which exam questions are taken." This has been a

condition precedent to providing "external advice and review" by these potential testing services. These professional testing services are in the business to make a profit. For obvious reasons, the Department of Insurance has felt that it would be improper to endorse one study manual over others; especially, when there is a pronounced pecuniary gain by the professional testing service for such an endorsement. Instead, we have relied on the professional staff of the Department and other insurance experts where there are no "strings attached" to assist us in this endeavor. Additionally, we believe that the partnership between the Department of Insurance and various technical educational colleges throughout South Carolina to administer the examination on the Department's behalf has functioned well and has served to meet the statutory responsibilities of this agency and the mission of those institutions in a sound manner and at the least cost to those taking the examination.

18. The General Assembly may wish to consider enacting legislation to require continuing education for insurance agents.

This recommendation is a Legislative Recommendation of the South Carolina Insurance Commission and Department of Insurance.

19. The department should develop a comprehensive written plan for analyzing insurer financial statements.

We agree. This Department will develop a comprehensive written strategy which will provide a clear audit trail so that future auditors can readily determine that the analysis process, which has proven to be very effective over the past fifteen years, is followed by all current and future financial analysts.

20. The department should develop written criteria for evaluating that information, including the relative importance each factor has to the decision.

We agree. The Financial Analysis Section's Annual Statement Checklist Sheet was developed years ago and has been refined throughout the years. It is primarily intended to assist the analysts in executing their statutory mandate to oversee the financial condition of insurance companies licensed in this state. This Checklist has proven to be of great value in selecting those insurers which merit the highest priority. This process allows the analysts to allocate and direct their resources in the best possible manner. Nevertheless, developed written analysis criteria for evaluating an insurer will be reduced to writing.

21. The department should further automate the financial condition analysis section so that the depth of analysis for all companies can be increased.

We agree. Effective with the 1990 Annual Statements, we began the process of using the insurer's financial information which is available in "machine readable" form. We will continue to automate the Financial Condition Analysis Section with the greatest possible speed within prescribed budgetary constraints.

22. The examination section should develop written work plans for each examination. These plans should be based on the procedures recommended by the NAIC, South Carolina law, and the individual conditions of the insurer under examination.

We agree and have done so. All financial examiners currently have a detailed procedures manual, developed by this Department, which provides for the adequate planning and documenting of solvency examinations. These plans were based on procedures recommended by the NAIC, South Carolina laws and regulations and the individual conditions of the insurers under examination.

23. The examination section should develop written working paper documentation standards. These standards should include procedures to link the work performed directly to the examination plan.

We agree and have done so. Written working paper documentation standards which link the work performed directly to the written work plans are currently in place and in use by the examination staff.

24. The department should develop written policies and procedures for ensuring that state laws pertaining to regulating and disciplining financially unsound companies are uniformly enforced.

We agree, and since June 1989, the Department has made use of the NAIC Troubled Insurance Company Handbook. This handbook is intended to assist insurance departments in dealing with and identifying troubled insurance companies, selecting regulatory courses of action, developing procedures for discharging responsibilities and structuring and organizing insurance departments to achieve these objectives. In addition, Section 38-5-120 of Act No. 13 of 1991 sets forth specific standards for dealing with an insurer that is in an unsound or hazardous condition. This law is permissive in nature and encourages the Commissioner to tailor his regulatory response to the specific conditions of the troubled insurer. For instance, the Commissioner may reduce or limit the volume of South Carolina business being written which provides the same benefits of a suspension order without the need to enter into a formal order.

25. The department should continue to seek expanded and upgraded computer processing capabilities to improve the efficiency of its operations.

We agree. The Department of Insurance completed installation of eight additional personal computers (PC's) during the week-ended May 3, 1991. This brings the Department's inventory of PC's to 41. All PC's are LAN attached and have access to the various NAIC databases in Kansas City, Missouri. Also, the Department completed in April, 1991, the installation of a new 56KB circuit between the Department and the DIRM mainframe at 300 Gervais Street. This circuit is in addition to a 9.6KB circuit also connected to DIRM. The Department has requested and received approval for replacement of the present IBM100 System. The replacement of this system is contingent upon receiving funding in Fiscal Year 1991-92. That funding is doubtful.



In conclusion, we welcome the recommendations made by the Legislative Audit Council, and we appreciate the courtesies extended to us by your staff members who participated in the audit.

Respectfully,

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Chairman
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